bottlenecks, and thereby create an effective competitive access market by the end of the process. Furthermore, potentially anti-competitive deregulatory measures, such as RFP and contract rate authority, should be placed at the end of the phase-ins, not at the beginning.

The original phase-in proposed in the Price Cap Second FNPRM seemed to understand better the importance of sequencing. Phase I would have simplified the treatment of new and innovative offerings and removed lower service band indices, and perhaps requiring a certain measure of competition "for a particular service or service within a prescribed geographic market before the proposal would be effective" (¶ 2). At Phase 2, upon demonstration of "substantial competition," ILECs could place services under streamlined regulation permitting the filing of tariffs on 14 days' notice without cost support or upper or lower service band indices. Not until Phase 3 would ILECs have received nondominant carrier treatment, thereby permitting geographic deaveraging (id.). In particular, the Commission reaffirmed its existing limitations on ICB and contract pricing (at ¶ 61-65).

The difference in sequencing in the Access Charge Reform NPRM is staggering. Lower service band indices are jettisoned immediately, special access is proposed to be deregulated immediately (¶ 153), and ICB and contract pricing would be granted in Phase I! Nowhere in the Access Charge Reform NPRM is

there any explanation for this total reversal in sequencing, nor could there be any logical explanation.

Adoption of the Telecommunications Act of 1996 certainly cannot explain this 180 degree about-face, since the key pro-competitive aspect of the 1996 Act, the Commission's Section 251 and Section 252 regulations, have been stayed by the Eight Circuit, and may be set aside in their entirety.

Nor is there any new market data or analysis supporting this flip-flop. Indeed, the Access Charge Reform NPRM is internally inconsistent. It asks whether special access services "should be removed immediately from price cap regulation," while elsewhere it relies on SWB's representation that dedicated transport costs "five times more in low-density area than in high-density areas" (at ¶ 107) to support a proposal that the ILECs be granted a "transitional mechanism" under which they could "deaverage its rates downward in high-density areas to permit [them] to respond to competition, while leaving its other rates unchanged in order to permit it to continue recovering the existing contribution included in those rates" (at ¶ 114).

The assumptions underlying these proposals are fundamentally inconsistent. If the ILECs can sustain huge disparities in dedicated transport rates (i.e., maintain significant price discrimination), then it is impossible for the Commission to conclude there is adequate competition to support the immediate deregulation of all special access services.

Finally, the Access Charge Reform NPRM proposes granting ICB and contract authority to the ILECs in Phase 1, stating (at ¶ 195): "Parties advocating that we should delay contract carriage until Phase 2 or until substantial completion has been reached should identify and quantify their concerns with implementing this reform at Phase 1." ALTS hereby strenuously objects to this proposal as unexplained and utterly inconsistent with the Commission's Interexchange Order and the Price Cap Second NPRM. The Interexchange Order only permitted AT&T to streamline its business services upon a finding of substantial competition -- that its market share had dropped to 39%-55% (at ¶ 112, n. 178). Here the only market data of record shows the ILECs provide over 97% of all access, in addition to their continued control of bottleneck facilities.

C. The Commission Should Abandon Its So-Called Market-Based Approach and Return to the Task of Removing Competitive Barriers.

The defects in the Commission's current market-based approach are so profound that the Commission should abandon it entirely, and return to the approach urged by ALTS in the Price Cap Second FNPRM:

- First and foremost, the Commission must correct the deficiencies and problems still outstanding in its Expanded Interconnection proceeding.

- The Commission should employ quantitative analysis and quantitative phase-in triggers linked to specific access markets, much as it did in the gradual deregulation of AT&T.

- The Commission should radically rearrange the phases of its proposed ILEC access regulation relief to resemble those

originally proposed by ALTS in CC Docket No. 94-1.

II. THE PRESCRIPTIVE APPROACH IS UNNECESSARY AND UNDESIRABLE IF THE COMMISSION CURES ITS SO-CALLED MARKET-BASED APPROACH. IF NOT, THE PRESCRIPTIVE APPROACH SHOULD ONLY BE IMPLEMENTED VIA AN EXTENDED PHASE-IN.

The Access Charge Reform NPRM never offers any justification for pursuing a prescriptive approach to access charge reform rather than a properly constructed market-based approach. The reason for this silence, of course, is that no justification exists. The central reason both Congress and the Commission have concluded markets should be relied upon to set prices rather than regulation is that regulation, despite the best efforts of the regulators, has proven totally unable to replicate competitive results. Lapsing back now to "prescriptive" regulation is a white flag of surrender totally inconsistent with the Telecommunications Act of 1996, as well as with the Commission's longstanding goal of furthering competition. The prescriptive approach should only be used if the Commission is unwilling or unable to correct the errors in its market-based approach, and then it should only be applied after the Commission has completed the removal of the entry barriers described supra in Part I.

The Access Charge Reform NPRM asserts that "[i]n both the prescriptive approach to access reform discussed in this Section and the market-based approach discussed in Section V, we seek to develop competition for interstate access services, which will ultimately result in the deregulation of these services" (at ¶ 220). But this is patently untrue of the prescriptive

approach, which would lower the prices of incumbent access charges, and thus reduce incentives for competitive entry.

In opposing the prescriptive approach, ALTS wishes to make it clear it is not seeking "umbrella pricing" from the Commission. ALTS and its members would be the principal beneficiaries if regulatory barriers could be removed and effective competition implemented overnight. But until those happy goals are achieved, ALTS will strenuously object to the "voodoo" regulation reflected in the prescriptive approach, where reductions in ILEC access prices are supposed to foster access competition.

There is nothing sinister or underhanded in new entrants first attacking higher profit markets, and then migrating to adjacent markets. This is precisely the pattern followed by MCI and other long-distance competitors, and it follows the ordinary pattern whenever competition in injected into monopoly markets. Mandating an arbitrary and unsupported reduction in the current margins of the access markets will unnaturally retard the emergence of access competition -- not assist it.

In addition to the anti-competitive effect of a prescriptive approach as compared to a properly constructed market approach, it is clear a prescriptive approach could not be justified as more immediately bringing benefits to long distance consumers. End user prices in the long-distance industry are set competitively, not by regulation. Any attempt to link a

prescriptive reduction in ILEC access charges to a mandatory reduction in long distance rates would be doomed to failure, even if it were within the Commission's existing authority.

Finally, the costing models currently proposed for use in a prescriptive approach are not adequate to be totally relied upon to shift the huge amounts of revenue that would be reallocated in a prescriptive approach to ILEC access charge reform, amounts which totally dwarf the modest levels involved in the Local Competition Order's use of cost models, such as Hatfield and BCM. ALTS applauds the Commission's industrious inquiry into cost modeling, and looks forward to improvement in all current approaches, including the upcoming Hatfield version 3, but it clearly is premature to place massive reliance on the precision of current modeling when a properly constructed market-based approach provides an even better way of achieving effective access competition.

Based on the foregoing, ALTS opposes any use of a prescriptive approach instead of a properly constructed market-based approach. If the Commission does adopt a prescriptive approach, ALTS asks that it employ a phase-in of at least five years like that recommended by Ameritech (at ¶ 114).

III. RATE STRUCTURE ISSUES

ALTS supports the overall thrust of the Access Charge Reform NPRM to move ILEC access charge rate structures closer to their underlying economic cost. Cost-based ratemaking is not just a

theoretical goal, it is a practical necessity if substantial competition is really to develop in all access markets.

A. SLC and CCL Restructuring

ALTS agrees with the Access Charge Reform NPRM's proposal to shift more recovery of interstate non-traffic sensitive ("NTS") loop costs from the minute-of-use ("MOU")-based Carrier Common Line ("CCL") charges to end users via removal of current caps on Subscriber Line Charges ("SCLs") for non-primary residence lines and business lines in general.

The ILECs have long contended that the recovery of non-traffic costs via a traffic-sensitive charge imposed a burden upon the ILECs' ability to compete for high toll volume access customers (a burden that could not have been too extreme, given that competitive providers have claimed only 2.7% of the total access market). Mitigation of this burden will cure a major complaint of the ILECs concerning supposedly unfair competition.

For those ILECs where removal of these particular SLC caps fails to achieve full interstate NTS recovery, the Commission needs to be careful in deciding how their remaining NTS costs will be recovered. In particular, the Commission should not try to solve such problems by means of capacity plans (sometimes referred to as "bulk billing" plans) because the trailing recovery component of such plans deters customers from switching to competitive access competitors (i.e., because all capacity plans necessarily rely on historical performance, IXCs would

still have to pay some amount to ILECs for past traffic even after switching that traffic to a competitive provider of access).

B. **Tandem Rate Structures**

ALTS agrees with the Access Charge Reform NPRM's proposal that dedicated flat-rated charges should apply to all facilities serving dedicated traffic. Currently, IXCs have the choice of either paying MOU charges for transport from the serving wire center ("SWC") to end offices based on airline mileage from the IXC location to the end office, or paying flat-rated charges for the transport from the SWC location to the tandem, and then MOU charges from the tandem to the end offices (at ¶ 87).

The Access Charge Reform NPRM is clearly correct that such a choice is anti-competitive. Correcting this distortion by requiring that the ILEC facility between the IXC and the tandem switch be rated as a Dedicated Transport facility would help create important opportunities for competition in these markets.

As to the elimination of the MOU pricing option for the Common Transport portion of tandem access, ALTS does not oppose the creation of a flat-rate option, provided that Common Transport revenues were also unbundled from all other parts of tandem transport and switching.

C. **Transport Interconnection Charge**

There is little question the D.C. Court of Appeals was correct in remanding the current Transport Interconnection Charge ("TIC") back to the Commission. Competitive Telecommunications Association v. FCC, 87 F.3d 522 (1996). The readily correctable cost misallocations include 80% of the tandem switching revenue requirement, some SS7 costs, and some assumptions regarding the comparability of direct trunked transport costs and special access.

ALTS believes the Commission should quantify and eliminate all readily correctable cost misallocations in its current access tandem switching regime (in particular, by creating a NTS switching element similar to that endorsed below for local switching), and in its tandem transport rate structure. Once this is accomplished, the Commission should rely on market-based forces to reduce any remaining TIC, relying on a long-term phase down only as a fall-back. All of these changes could serve to make tandem switched access markets more open to competition.

D. **Local Switching**

ALTS agrees with the Access Charge Reform NPRM's proposal to disaggregate switching costs into traffic-sensitive and non-traffic sensitive portions, and to allocate non-traffic sensitive costs, such as switch ports, to the latter.

E. Takings Issues

ILECs continue to insist that any reductions in their access revenues, whether by a market-based approach or a prescriptive approach to access charge deregulation, would constitute a Fifth Amendment "taking." But it is plainly premature for the Commission to attempt now to address such claims in the absence of any quantification from the ILEC industry.

Once the final version of access charge reform is ready for implementation, the ILECs will then be in a position to raise their Fifth Amendment taking issues concretely. In particular, the ILECs should be free to charge their end users for any amounts that are necessary to insure their constitutionally minimal recovery provided that any such charges are: (1) clearly identified to end users; (2) supported by public calculations of the "shortfall" which identify the under-recovery involved, and the relevant time periods; and (3) are shown not to have been recovered in any other charges or manner.

IV. REGULATION OF NEW ENTRANTS

There is absolutely no need for the Commission to impose regulation on new entrants. The cost of compliance would be yet an additional structural regulatory barrier to companies that comprise less than 3% of the total access market.

There is no economic rationale in the Access Charge Reform NPRM for imposing regulation on competitive access. The only factor mentioned in the Access Charge Reform NPRM in support of

such regulation is the assertion that "new entrants appear to possess market power over IXCs needing to terminate calls" (at ¶ 279).

This is balderdash. Putting aside the issue of ILEC market power over terminating access in the absence of competitive alternatives, there is no such power for competitive providers. Take the simple example of a person who builds and leases a business park. If local law or leases do not control the prices and availability of certain essential utilities (say electricity), the landlord might think she could permanently increase the value of her property by providing electricity to the tenants at greatly inflated prices.

The outcome of such a plan is obvious. Tenants with escape clauses in their leases would move, or threaten to move unless they obtained reductions. And those who were stuck would express their displeasure so vocally that the landlord would forced to abandon her strategy when the leases came up for renewal. Rather than increasing the value of her property, such a strategy would probably decrease its value so long as it remained under her management.

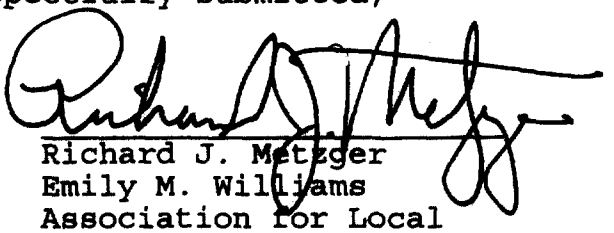
The same fundamental factors are equally applicable to the competitive access industry. The first competitive access provider foolish enough to attempt to exploit any perceived market power over terminating access would find itself quickly brought into line. For example, its access customer might start

getting letters from end users who had been informed they could no longer reach the access customer, or else would be surcharged for such calls. Given that most current competitive access customers are businesses, such letters would not be well received. Further, the CLEC might find itself slapped by surcharges on any originating traffic it subsequently tried to deliver to an "exploited" IXC, again angering its underlying customer. A more scholarly explanation is provided in Local Telecommunications: Competition and Bottlenecks - A Response to Gillan and Rohrbach by Brenner and Woodbury (appended as Attachment B), but the simple fact is that free markets are very good at disciplining bad actors who cannot run away from large fixed capital assets.

CONCLUSION

For the foregoing reasons, ALTS requests that the Commission reform the current ILEC access charge regime consistent with the pro-competitive intent of Congress reflected throughout the 1996 Act.

Respectfully submitted,

By: 

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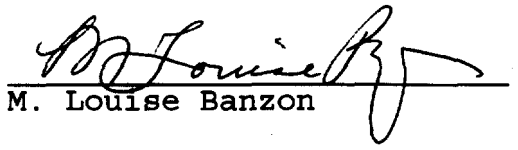
January 29, 1997

CERTIFICATE OF SERVICE

I hereby certify that the foregoing comments of the Association for Local Telecommunications Services was served January 29, 1997, on the following persons by First-Class Mail or by hand service, as indicated.



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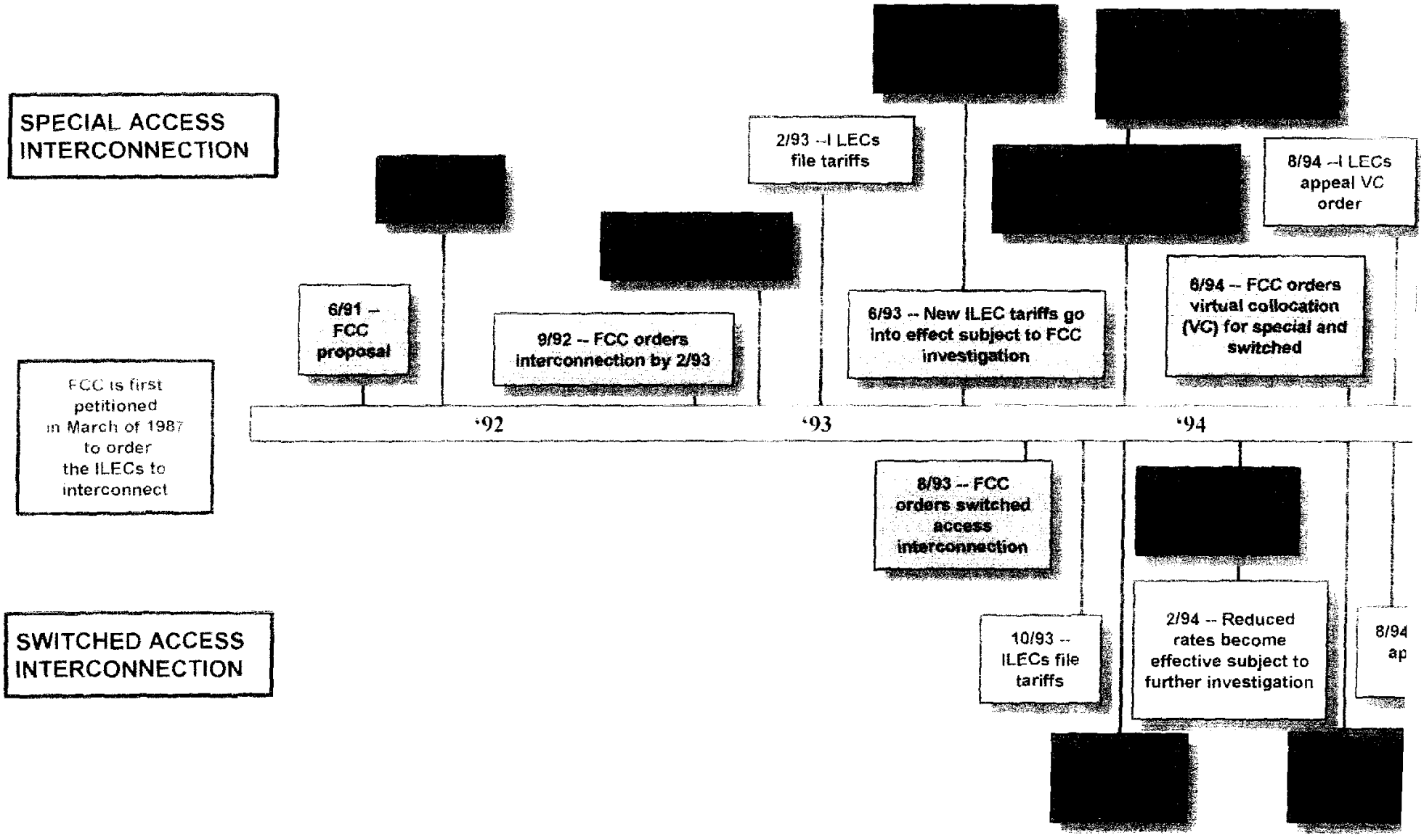
ASSOCIATION FOR LOCAL TELECOMMUNICATIONS SERVICES - A

HOW THE ILECS STONEWALL ACCESS COMPETITION: ALMOST TEN YEARS AT TH FCC, AND MOST INTERCONNECTION TARIFFS ARE STILL UNDER INVESTIGATION



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ATTACHMENT B

Local Telecommunications: Competition and Bottlenecks - A Response to Gillan and Rohrbach

by

Steven R. Brenner
and
John R. Woodbury

Charles River Associates

August, 1994

Executive Summary

Local Telecommunications: Competition and Bottlenecks -- A Response to Gillan and Rohrbach

by

Steven R. Brenner and John R. Woodbury[1]

This paper responds to a recent paper by Joseph Gillan and Peter Rohrbach.[2] Gillan and Rohrbach (hereafter "GR") argue that the entry of new local carriers is likely to lead to the reconcentration of the telecommunications industry and the need for increased regulation. GR, however, provide no convincing reason either to believe in their dark vision of the future or to accept that new regulations will be needed to deal with its problems. The arguments the authors offer to support each step in their story are inconsistent with sound economic analysis and market experience.

The linchpin of the GR argument -- and its central fallacy -- is that the emergence of new local carriers will substitute a "new 'multi-bottleneck' for the single bottleneck of today's monopoly." This concept of "multi-bottleneck" is an economic oxymoron without support in economic analysis. A bottleneck is created by unified control of a unique, essential facility or service. Increasing the number of local carriers supplying services that previously were bottlenecks creates alternatives and competition, and dissolves bottlenecks rather than multiplying their number.

I. Local Carriers Have No Economic Imperative to Serve Only End Users

GR begin by asserting that new local carriers will have an "economic imperative" to sell loop services to end users in order to control end-user revenue. According to GR, intermediate services, such as dedicated transport, generate too little revenue to be an attractive business for new carriers.

GR claim their conclusion is "validated" by their table of revenue opportunities that purports to show that only 3% of local telephone companies' revenues are addressable by a network that extends to the central office. According to GR, local carriers will extend their networks to supply local loops and sell to end users in order to seek the remaining 97% of revenues. This is unconvincing.

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[1] Drs. Brenner and Woodbury are vice presidents of Charles River Associates.

[2] "The Potential Impact of Local Competition on Telecommunications Market Structure: Diversity or Reconcentration?"; March 1994.

- Such revenue opportunities alone say nothing about what services new local carriers will provide. Local carriers will extend their networks only if doing so is profitable, which depends not simply on revenues but on the costs of providing the services that would earn those revenues. GR never consider whether it would be profitable for local carriers to behave as they predict.
- New local carriers, CAPs, today earn a substantial portion of their revenue by selling intermediate services to IXCs, services such as dedicated transport for access traffic and capacity to connect IXC POPs to the IXC network. It is most unlikely that they will turn their back on such profitable services in the future, even if they find it profitable to supply some local loops and sell more services directly to end users. Local carriers are likely to continue to play a variety of roles, suppliers of dedicated or switched services to some customers, suppliers of dedicated access transport to IXCs, and carriers' carrier to IXCs and even to other local carriers.

II. Local Competition Will Not Create a "Multi-Bottleneck"

GR argue that, even if customers have a choice of suppliers of their local loop, long distance and information service companies will still face a bottleneck, a "multi-bottleneck" in their phrase, when they purchase access services. This GR concept of a "multi-bottleneck" is internally contradictory and inconsistent with sound economic analysis. A bottleneck is created by an absence of alternatives. Even if GR are correct that new local carriers will sell to end users, if customers can choose from among more suppliers of local loops, the result will be more competition, not more bottlenecks.

- GR ignore the reasons why local competition would prevent a local carrier from exercising market power over interexchange carriers.
    - Interexchange carriers and information service providers purchase access services as inputs to services they sell to end users. Higher prices for the input, access service, means higher prices or reduced service - or both - for end users.
    - If a local carrier charges high prices for access service, interexchange carriers will have a strong incentive to charge customers who use that local carrier higher prices for interexchange service. Interexchange carriers can use both their billing practices and their marketing muscle to make it very clear to end users that it is they who will pay if they choose a local carrier that sets high prices for access service.
    - Competition among local carriers to sell to end users also will limit the ability of carriers to charge interexchange carriers more for access service, because ultimately it is the end user that pays.
- The GR concept of a "multi-bottleneck" hinders rather than helps understanding the competitive effects of new local carriers, because it denies

rather than evaluates the consequences of entry and local exchange competition.

III. Vertical Integration of Local and Interexchange Carriers Is Neither Inevitable Nor Necessarily Harmful

GR claim that local carriers necessarily will vertically integrate with interexchange carriers and information service providers to become "full service providers," and the consequence will be exclusion and foreclosure of stand-alone interexchange or information service rivals.

- GR present a very distorted perspective on the role and effects of vertical integration by focusing only on foreclosure. Their discussion ignores three important lessons taught by economic analysis and observation of the economy.
    - Vertical integration is neither inevitable nor ubiquitous.
    - Where firms do vertically integrate, that arrangement can offer real efficiencies and benefits to consumers.
    - Firms can and regularly do vertically integrate without excluding or foreclosing unaffiliated firms.
- At least some market evidence casts doubt on whether local and interexchange carriers will find it efficient to vertically integrate. For several years CAPs have been building substantial local facilities and supplying services to IXCs. Yet vertical integration between interexchange carriers and CAPs has been the exception rather than the rule. Interexchange carriers might have chosen to begin or invest in CAPs, yet in most cases they have not.
- While vertical integration is not inevitable, telecommunications firms have formed and probably will continue to form various kinds of vertical relationships, including some vertical integration. Such relationships, however, need not be exclusive and in any case should not be viewed solely as a source of anticompetitive harm.

IV. New Local Carriers Are Unlikely to Try Anticompetitive Foreclosure

GR see foreclosure as the obvious and inevitable consequence of vertical integration and the "multi-bottleneck" control they attribute to new local carriers. Anticompetitive foreclosure, however, is *not* the inevitable natural consequence when firms vertically integrate, and GR offer no reason to expect that consequence if local carriers and interexchange carriers do combine.

- GR try to argue by analogy that new, integrated local carriers will use their "multi-bottleneck" control to foreclose rivals, just as the pre-divestiture Bell Operating Companies had the ability and incentive to use their bottleneck control anticompetitively. This analogy will not stand examination.

- The pre-divestiture BOCs had true bottleneck control; legal barriers insured they had a monopoly over the supply of local loops. In contrast new local carriers always face at least one rival, the incumbent local exchange carrier, may compete with other new entrants, and are not protected by legal barriers from further entry.
- Increased local competition invalidates the GR analogy. A local carrier for whose services customers have good alternatives does not have the ability to harm unaffiliated interexchange carriers in order to help an integrated interexchange carrier.
- GR claim "multi-bottleneck" control would give local carriers the ability to foreclose stand-alone rivals, but this is a fallacy. Local carriers will not have bottleneck control if there is local exchange competition.

- There are sound reasons to be skeptical of claims new local carriers could or would try anticompetitive foreclosure.
  - Competitive alternatives will constrain the ability of new local carriers to foreclose, even if competition is not widespread enough to eliminate the market power of the incumbent local exchange carrier.
  - Attempts to disadvantage well-established, stand-alone interexchange carriers will make it harder to attract or keep customers who prefer those carriers. The new carrier would have to convince these customers that its local service was worth their changing interexchange carriers or paying higher prices for their preferred interexchange service.
  - Local carriers could lose business, such as for dedicated access transport, that they otherwise could sell directly to stand-alone interexchange carriers.

V. Extending Regulation Of New Local Carriers Promises Costs But Few Benefits

GR argue for imposing new regulatory restraints on new local carriers:

- The rates and terms local carriers charge for access to their loop services, GR claim, should be regulated "for the foreseeable future" regardless of how competitive is the supply of local loops and service.
- All local carriers should be required to make specified local services available at "wholesale" rates, with regulation controlling the relationship between the rates the local carrier charges for wholesale and retail service.

The Gillan and Rohrbach paper provides no basis for concluding that the benefits of these policies would exceed their costs.

- GR argue these regulations are needed because local carriers will have "multi-bottleneck" control regardless of the extent of local exchange competition. This paper shows competition would constrain the ability of local carriers either to exercise market power in selling access services to interexchange carriers or to foreclose interexchange carriers.
- The best way for policy to attack bottleneck control where it does exist and prevent anticompetitive foreclosure is with policies, such as number portability, that encourage competition by making it easier for customers to change carriers and that reduce barriers limiting entry or the range of services for which new carriers can provide competition. Entry of new local carriers should help solve these problems, not extend them.
- The GR proposal that local carriers be required to sell services at wholesale could prevent the telecommunications industry from adapting to new competitive possibilities. It would lock in a particular vertical market structure that may or may not be efficient, and protect the position of particular firms with a stake in that structure.
- The extension of regulation proposed by GR would impose substantial, new regulatory costs by deeply involving regulators in the pricing and design of services offered by new carriers.

VI. Conclusions

The Gillan and Rohrbach paper begins with a paradox: more local competitors will result in more bottlenecks instead of more competition. On this foundation, the authors build their story that more bottlenecks will lead to vertical integration and foreclosure, and their claim that sweeping new regulations are needed. Economic analysis tells us the paradox is really a contradiction. More suppliers of local loops would increase competitive pressures and dissolve bottlenecks, not create new ones. Vertical integration is not inevitable and, to the extent it occurs, is not synonymous with foreclosure and reduced competition. Extensive additional regulation of new local carriers is most unlikely to offer the benefits Gillan and Rohrbach foresee, but it surely would impose substantial costs.

Local Telecommunications: Competition and Bottlenecks --

A Response to Gillan and Rohrbach

by

Steven R. Brenner and John R. Woodbury[1]

In a recent paper, Joseph Gillan and Peter Rohrbach[2] present their view of how telecommunications market structure and competition are likely to evolve, and propose new regulations to handle problems they foresee. Gillan and Rohrbach (hereafter "GR") foresee new local carriers supplying local loops and focusing nearly exclusively on selling services to end users. They foresee each local carrier integrating with an interexchange carrier and dealing almost exclusively with that affiliated IXC. For GR, each stage in this evolution is ominous and requires a regulatory response. Local carriers will not simply sell to end users, but "control" them, giving the new carriers market power over interexchange carriers purchasing access. Local carriers and interexchange carriers will integrate not because it is efficient, but in order to foreclose and exclude unaffiliated interexchange carriers.

Gillan and Rohrbach, however, provide no convincing reason either to believe in their dark vision of the future or to accept that new regulations will be needed to deal with its problems. The arguments offered by the authors to support each step in their story are inconsistent with sound economic analysis and market reality.

The linchpin of the GR argument -- and its central fallacy -- is that the emergence of new local carriers will substitute a "new 'multi-bottleneck' for the single bottleneck of today's monopoly."[3] Their concept of "multi-bottleneck" is an economic oxymoron without support in economic analysis. A bottleneck is created by unified control of a unique, essential facility or service and the absence of alternatives. Increasing the number of local carriers supplying services that previously were bottlenecks will

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[1] Drs. Brenner and Woodbury are vice presidents of Charles River Associates.

[2] "The Potential Impact of Local Competition on Telecommunications Market Structure: Diversity or Reconcentration?"; March 1994.

[3] GR, "Executive Summary," p. 2.

increase alternatives and competition and dissolve bottlenecks rather than multiply their number.

I. Local Carriers Have No Economic Imperative to Serve Only End Users

GR begin by asserting that new local carriers[4] will have an "economic imperative" to build local loops and sell local service directly to end users in order to control end-user revenue.[5] According to GR, intermediate services, such as dedicated transport of access traffic, generate too little revenue to be an attractive business. This imperative is an important part of the GR story, dictating that local carriers play only the role GR assign them: sellers of loops that control a portion of the "multi-bottleneck." GR's vision leaves no place for a more complicated, and more realistic, market environment in which local carriers -- whatever their hopes of selling directly to end users -- take advantage of a range of profit opportunities to supply and promote their sales of a variety of intermediate services to IXCs and others as well as services to end users.

The arguments presented by GR in fact provide no support for the existence of their imperative. GR claim to "validate" their conclusion that new local carriers will be driven to supply end users directly by classifying telecommunications revenues into two categories of revenue opportunities.[6] GR find that "only 3% of the local telephone companies' revenues are addressable by a network that extends to the central office," and conclude that this means that "[t]he real opportunity [for local carriers] rests with connecting directly with the end user...."[7]

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[4] This paper uses the terms "local carriers" or "new local carriers" to refer generically to suppliers of local telecommunications services of any type. This label is used in preference to the GR label, "local service carriers," or competitive access providers (CAPs), in order to be less restrictive in suggesting the type of services to be provided. The term "local exchange carrier" (LEC) is reserved for the incumbent local carrier, as it is in GR.

[5] GR at page 4.

[6] GR put only $2.8 billion in their "collocation" category, those said to be "addressable" by a local network that extends only to the end office: a portion of special access revenues and roughly 10 percent of switched access revenues. The remainder, $91.2 billion, GR put into the second category, end-user revenues: all local revenues ($30.5 billion); all interLATA toll revenues ($33.6 billion, net of access); all intraLATA toll revenues, ($9.7 billion); and the balance of access revenue ($17.4 billion). See GR at page 5. According to GR, the data they use are 1991 revenues of the RBOCs, plus interLATA toll revenue.

[7] GR at page 6.

In fact, this comparison of revenue "opportunities" by itself says exactly nothing about which services new local carriers will supply. Of course there are more revenues to be earned selling a full range of local services and interexchange toll service than selling only dedicated transport services from end offices to IXC POPs.[8] New local carriers will extend their networks and supply more services, however, only if doing so is profitable. To supply the additional services, local carriers would have to invest in much larger networks. GR's revenue opportunities are worth nothing to carriers unless they can supply the additional services as efficiently as the other carriers with which they must compete. Looking only at revenues says nothing about what services new local carriers can provide profitably.

To make the point by rough analogy, one might as well claim that tire manufacturers have an economic imperative to begin selling automobiles to customers because the revenue from selling cars directly to customers is, say, twenty or thirty times greater than the revenue "addressable" by selling tires to automobile manufacturers. Or, one could use the same sort of revenue comparison to "show" that interexchange carriers will have an imperative to produce automobiles, because surely the revenue opportunity from selling automobiles is far greater than the revenue opportunity from only selling interexchange services to automobile manufacturers.

One might object that these analogies are overdrawn. The businesses are so different that tire manufacturers and interexchange carriers obviously would not conclude that they could produce cars profitably. That, however, is precisely the point. One cannot determine what a firm is likely to produce by looking only at such revenue opportunities. The substantive question is: What can firms produce efficiently and profitably? This question is not even posed by GR, let alone answered.

Competitive access providers ("CAPs"), which are new local carriers in the terminology of this paper, today earn a substantial portion of their revenue by selling intermediate services to IXCs, services such as dedicated transport for access traffic and capacity to connect IXC POPs to the IXC network. In the future, CAPs and other new local carriers may find it profitable to supply more direct connections and services

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[8] Indeed, it is far from clear why interLATA toll revenues should be included as an addressable revenue opportunity for a local telephone carrier. Yet interLATA revenues make up more than one-third of the revenues GR allocate to the end-user category.

to end users -- although they surely will not blindly pursue revenue opportunities, and it remains to be seen how many such opportunities will be profitable. Even if they sell more to end users, however, it is most unlikely that, as GR suggest, local carriers will turn their back on selling profitable intermediate services to IXCs. Local carriers are likely to continue to play a variety of roles, suppliers of dedicated or switched services to some customers, suppliers of dedicated access transport to IXCs, and carriers' carrier to IXCs and even to other local carriers. Their behavior and role in the market will be shaped by the desire to pursue this full range of profit opportunities, and not by the single business of supplying local loops and service to end users.

II. Local Competition Will Not Create a "Multi-Bottleneck"

New local carriers will supply *some* direct connections to end users. The important policy question is not whether local carriers will supply local loops, but: What are the consequences? GR argue that, even if customers have a choice of suppliers of their local loop, long distance and information service companies will still face a bottleneck, a "multi-bottleneck" in their phrase, when they purchase access services. Having multiple suppliers of local loops will not eliminate the bottleneck faced by long distance and information service companies because, in GR's words, these companies "still will have to deal with the LSC [Local Service Carrier] selected by the customer" to supply the loop. "Once a LSC has sold a customer a local loop (in competition with any other LSC), it can then exploit the loop against third parties who require access to it."[9]

This GR concept of a "multi-bottleneck" is internally contradictory and inconsistent with sound economic analysis. A bottleneck is created by an absence of alternatives. If customers can choose from among more suppliers of local loops, the result will be more competition, not more bottlenecks. Competition among local carriers will not somehow be limited to services the carriers sell directly to end users. Even if GR are correct that local carriers will concentrate on selling directly to end users, the consequence will not be the creation of a "multi-bottleneck."

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[9] GR at page 10.

GR use the metaphor of a kidnapping and ransom to explain their point: local carriers will capture or kidnap end users in order to "obtain ransom from others for access to those customers."[10] The fundamental fallacy of their analysis, to continue the metaphor, is its inability to explain why customers should volunteer to be kidnapped when, ultimately, they will have to pay their own ransom.

GR apparently believe that selling local loop services to end users and selling access services to interexchange carriers are independent, unconnected transactions. They claim that "attraction of end user customers only requires the LSC to offer competitive rates for the service that the subscriber purchases: local. Once the subscriber has chosen its local loop provider, all other users of that network component will be as much a captive of the new LSC as they are today of the LEC." This argument ignores the stake an end user has in the pricing of access.

Interexchange carriers and information service providers purchase access services as *inputs* for services supplied to the same customers who would choose the supplier of a local loop. Higher prices for the input, access, mean higher prices or reduced service -- or both -- for the end user.[11]

Thus GR are wrong to imply that end users will not care if their loop provider tries to exercise market power in selling access service. Ultimately, market power exercised over interexchange carriers purchasing access service is market power exercised over the end users who purchase the long distance service. End users will care if a local carrier tries to exercise market power over a purchaser of access services, because end users will suffer the consequences of higher prices for interexchange service. Through this relationship, ignored by GR, competition in the supply of local loops to end users also would constrain the exercise of market power over purchasers of access services.

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[10] GR at page 4.

[11] The pattern of switched access charges and rates for long distance service over the past ten or so years demonstrates that these prices move up or down together. Substantial reductions in access charges have led to substantial reductions in long distance rates. (There is no dispute of this point, despite some disagreement about whether all reductions in access charges have been passed through to consumers.)